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SUBJECT: TURKISH MARKETS FALL SHARPLY ON EU CONCERNS
ARISING FROM PENAL CODE REFORM POSTPONEMENT

REF: A. ANKARA 5310

[1](#)B. ANKARA 5187

[1](#)1. (Sbu) Summary: No sooner had markets shown signs of beginning an autumn rally, than the GOT, ss handling of the adultery issue -- resulting in the postponement of the penal code reform and negative implications for Turkey,s EU accession prospects -- caused markets to fall sharply Friday, September 17 and Monday, September 20. The stock market fell 4.3 % Friday, and fell 3.5% more Monday morning, to return to the level in late August, and the lira fell to its lowest level of 2004 against the dollar at TL 1.54 million. Interest rates rose back to levels well above those prior to the Central Bank,s September 8 rate cut. With a heavy domestic debt redemption calendar this week, the interest rate spike will cost the GOT millions of dollars in additional interest payments. End Summary.

Adultery Issue,s Turn for the Worse Scares Markets:

[1](#)2. (Sbu) The GOT,s moves since late August to amend the Turkish penal code to criminalize adultery did not alarm markets at first. Unlike with the Imam Hatip controversy in the spring, markets reacted calmly since the adultery issue was not perceived to be a significant source of friction between the GOT and the military that would threaten EU relations. By Thursday, September 16, however, it became evident that a faction of the AKP government and parliamentary group were determined to keep the issue alive, and when the leadership got caught up in the debate (ref a), markets started to take notice. When the government pulled the reform draft, which contained a range of legal reforms important for meeting the EU's Copenhagen accession criteria, many investors headed for the exits.

[1](#)3. (Sbu) Market participants, concerns stem from the implications of criminalizing adultery for Turkey,s EU accession prospects. Over the course of last week, several EU officials criticized the AK parliamentarians, push to criminalize adultery. Key among these statements was EU Enlargement Commissioner Verheugen's comments on the need to pass the penal code reform before the EU Commission report, expected October 6, in order to comply with the Copenhagen criteria. More importantly, however, markets were alarmed by the government's decision to pull the draft penal code, which contained other legal reforms considered key to a positive EU decision.

Erdogan,s Comments Spark a Sell-Off:

[1](#)4. (U) On the 16th, the markets began to reverse their previously positive tone: the stock market barely moved but the lira retreated from 1.491 million per \$ to 1.501 million, and the interest rate of the Government's benchmark bond rose from 24.35 to 24.46.

[1](#)5. (Sbu) In the middle of the day Friday, Prime Minister Erdogan made public comments that greatly exacerbated market worries, at the same time that the entire penal code reform--considered an important factor for the October 6 EU Commission report on Turkey and, ultimately, the December EU decision on Turkey,s candidacy--was pulled. Erdogan took a harsh, defensive tone, saying, "Let nobody try to pressure Turkey by using the EU..." and "Nobody should try to impose conditions on us concerning the EU." The shelving of the penal code changes, with parliament on recess until October 1, just five days before the release of the EU Commission report, greatly added to market worries that the GOT had allowed the debate over the adultery issue to greatly reduce the odds of a favorable EU report.

[1](#)6. (Sbu) In late afternoon trading Friday, the markets pulled way back. The IMKB 100 stock exchange index fell 4.3%

on the day, to 20,779.75, a level last seen on September 13. The lira depreciated sharply to TL 1.521 million to the dollar from 1.501 at the previous day's close. Interest rates, which had finally come down a bit after the Central Bank's September 8 rate cut (ref B), began to rise, with the benchmark reaching 24.93 at Friday's close, up from 24.35 at Wednesday's close. Turkish Treasury's domestic debt manager, Volkan Taskin, told us Friday that rates between 24.9 and 25%, if sustained during the week of September 20, would cost Treasury an additional TL 800 trillion (about USD 530 million).

17. (Sbu) Though Erdogan and Gul tried to downplay the problem over the weekend, and there are press reports that Erdogan and Verheugen are to meet on Thursday, September 23 in Brussels, the markets fell in morning trading Monday. The IMKB 100 stock index fell a further 3.5 % in the morning to 20,294 and the lira fell to a low for the year at TL 1.54 million to the dollar. Of the greatest importance, however, for the Turkish state's fragile financial situation, interest rates spiked: trading on the GOT's benchmark bond yielded interest rates of 27.10% in Monday morning trading over 170 basis points above the level prior to the Central Bank's September 8 rate cut. The timing of the increase in rates is particularly unfortunate: Treasury has a heavy calendar of redemptions (TL 6.8 Quadrillion, or USD 4.53 billion) and new borrowings this week.

Comment and Conclusion:

18. (Sbu) The market sell-off and the GOT difficulties in dealing with the EU have raised market analysts' concerns, but do not (yet) imply a crisis. Indeed most market analysts, while concerned, continue to place a high probability on a favorable--if conditional--response from the EU in December. Citibank, for example, reiterated its recommendation to investors to increase their holdings of Turkish assets. Nevertheless, the reversal in the markets demonstrates the potential for market volatility in the run-up to the December EU summit. From a broader perspective (ref A), the GOT's handling of the adultery issue seems to demonstrate that senior GOT leadership is either unable or unwilling to avoid missteps that risk serious damage to its EU accession strategy.

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